MASSACHUSETTS DEPARTMENT
OF
TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Telecommunications and Energy on its own motion, pursuant to G.L. c.164 §§ 76, 94, and 94A, to investigate the appropriateness of the use of Risk Management Techniques to Mitigate Natural Gas Price Volatility	**)))))**	**D.T.E. 01-100**

REPLY COMMENTS OF
DUKE ENERGY TRADING AND MARKETING, L.L.C.

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Dated at Washington, D.C.: February 12, 2002

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OF DUKE ENERGY TRADING AND MARKETING, L.L.C.

Pursuant to the Notice issued January 25, 2002 by the Department of Transportation and Energy (Department), Duke Energy Trading and Marketing, L.L.C. (DETM) hereby submits the following reply comments with respect to the Department's Notice of Inquiry regarding the appropriateness of Department regulated gas utilities employing risk management techniques in purchasing gas supplies to meet their franchise needs.

EXECUTIVE SUMMARY

DETM supports the use by the Massachusetts local distribution companies (LDCs) of risk-management techniques as a means of promoting gas pricing stability in the market, provided such risk-management programs proceed, at least initially, on a limited and closely-monitored basis. The majority of commenting parties — including, in particular, all but one LDC — concur with this approach, with the exception of the Attorney General. DETM's reply comments address the concerns expressed by the Attorney General, showing that properly-used hedging techniques will result in a net benefit to consumers.

REPLY COMMENTS

With one exception, the commenters generally supported the use of some form of risk-management techniques by the LDCs, mostly on a voluntary basis, while at the same time recognizing that risk-management techniques are intended to result in price stability, not the lowest possible cost of gas, and that any use of hedging techniques necessarily carries with it inherent costs and risks. The commenters did not disagree with DETM that a LDC employing hedging would need a clear understanding from the Department of how the LDC's actual experience with hedging would be judged for regulatory purposes. As to the specifics of the type of risk-management techniques and programs the LDCs should be permitted to use, the commenters presented several different opinions, ranging from no restrictions to a more controlled program.

Those commenters who supported LDC use of risk-management techniques proffered a variety of suggestions concerning the specific type(s) of programs that the Department could/should adopt if it chooses to allow some form of hedging by the LDCs. While DETM has its own preferences in this regard, as outlined in its initial comments, DETM will defer to the Department in devising an appropriate risk-management program for the LDCs it regulates. The more important and immediate issue, and the one which DETM will address herein, is whether the Department should allow ***any*** hedging program on any basis, as high lighted in the vigorous opposition of the Attorney General.

SUMMARY OF ATTORNEY GENERAL'S COMMENTS

The Attorney General "strongly recommends" against allowing the LDCs to employ hedging, because the risk of a substantial adverse financial result outweighs possible benefits. Instead, the use of hedging should be left to experienced traders working in the competitive marketplace. In support of its stance, the Attorney General notes the existence of price mitigation measures benefitting consumers that already are in place (such as six-month pricing, the availability of levelized billing, and the use of storage), and that there will be a cost to the Department for monitoring, analyzing, and judging LDC performance. In addition, the Attorney General argues that: (i) hedging has not been shown to provide net benefits to customers, (ii) the use of derivatives incurs necessary costs that must be included in any analysis of their value, (iii) hedging is unlikely to result in the customers "beating" the market, so hedging will result in net costs to consumers, (iv) hedging can produce "huge" losses (even for experienced firms which the LDCs are not), and (v) allowing LDCs to use hedging will stifle development of a competitive gas supply market.

DETM RESPONSE

The Attorney General has valid reasons for expressing concerns with the use of risk-management techniques by the relatively inexperienced LDCs. For instance, DETM concurs that hedging is intended to promote price stabilization and thus does not guarantee the lowest cost gas supply; that setting up and monitoring a risk-management program LDCs will involve the expenditure of resources by both the LDCs and the Department; and that any use of hedging techniques carries with it both costs and risks. DETM does not agree, however, that an intelligently created and carefully monitored hedging program will not be a benefit to Massachusetts consumers.

While there certainly are costs and risks associated with hedging, there also are direct costs and risks to Massachusetts consumers if they remain subject to the vagaries of the spot gas market. In fact, several of the commenters cited very recent instances where substantial unexpected price spikes were harmful to consumer interests, particularly to low income gas customers whose overall economic situation does not easily tolerate large energy price increases. As shown in the attached hedging example, the avoidance of price spikes through hedging is precisely the kind of net benefit to consumers which the Attorney General has overlooked in its decision to oppose any use of hedging by the LDCs.

The Attorney General's biggest fear, it seems, is that hedging could result in catastrophic losses for the LDCs which then would be passed through to customers. But that does not have to be a risk which the LDCs and their customers necessarily must assume. Rather, the possibilities of hedging losses can be limited if: (i) only those LDCs who volunteer to participate do so, (ii) if the Department restricts, in the beginning, both the annual or seasonal percentage of gas supply purchases that a LDC can hedge and the type(s) of hedging techniques a LDC can utilize, and (iii) if the Department allows the LDCs to partner with experienced gas trading organizations who can assist the LDC in developing and operating a risk-management program.

With a properly limited and monitored program overseen by the Department, the Massachusetts LDCs who are allowed to employ risk-management techniques will be able to mitigate price swings that otherwise would burden their customers.

CONCLUSION

For these reasons, DETM urges the Department to allow the LDCs to initiate the use of risk-management techniques, albeit on a limited and controlled basis. One possible approach would be for the Department to authorize an experimental program for any LDC that volunteers to participate according to the pre-set rules and understandings. The results of this experiment would be reviewed after a period of years to determine whether hedging would be a worthwhile addition to the gas supply purchase practices now in place. As DETM noted in its initial comments, DETM stands ready to assist the Department in setting up such a program and/or to help a participating LDC launch its own efforts at risk-management.

Respectfully submitted,

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HEDGING EXAMPLE

Long Hedges

Gas buyers [illegible]
prices have a [illegible]
allows them to [illegible]

* * *

Hedging Against a Natural Gas Price Increase by Buying Futures

Assume that [illegible]
an LDC, or a [illegible]
becomes con[illegible]
He purchases [illegible]

On Decembe[illegible]
spot market. [illegible]
closes out his [illegible]
results if the p[illegible]
$1.70 (Case B[illegible]

	Case A Prices Increase	Case B Prices Decrease
Dec[illegible]	[illegible]	[illegible]
Dec[illegible]	[illegible]	[illegible]
Gain or Loss on Futures		
Sale[illegible]	[illegible]	[illegible]
Purc[illegible]	[illegible]	[illegible]
Minu[illegible]	[illegible]	[illegible]
Cas[illegible]	[illegible]	[illegible]
Effe[illegible]	[illegible]	[illegible]

Summary of results: In Case A, [illegible]
but the financ[illegible]
effective gas [illegible]

In Case B, th[illegible]
had he not he[illegible]
decline, he w[illegible]
direction and [illegible]
ended up bein[illegible]
$2.20 for his [illegible]

Source: New York Mercantile Exchange, "RISK MANAGEMENT WITH NATURAL GAS FUTURES AND OPTIONS" at pages 34-35.